MNP LLP

SUBMISSION TO THE DEPARTMENT OF FINANCE ON THE AUGUST 12TH, 2024 LEGISLATIVE PROPOSALS RELATING TO CAPITAL GAINS

September 3, 2024

Submitted electronically at: Consultation-Legislation@fin.gc.ca

MNP LLP ("MNP") is pleased to make a submission in response to the Department of Finance, Tax Policy Branch (the "Department") request for comments on the August 12, 2024 draft legislative proposals with respect to capital gains (the "Proposals"). We appreciate the opportunity to provide our comments and recommendations.

MNP is a leading national accounting, tax and business consulting firm in Canada. MNP proudly serves and responds to the needs of our clients which include more than 280,000 private enterprise and small and medium-sized business clients throughout Canada.

EXECUTIVE SUMMARY

It is important to ensure that *certainty, predictability and fairness* to all taxpayers are all considered when establishing or amending tax legislation. These principles are the foundation of tax law.

The capital gains inclusion rate increase announced in the 2024 federal budget ("Budget 2024") has widespread impact on Canadian business owners and other taxpayers. Despite being a significant change, the process thus far to detail and implement this change has been far from smooth. Given the short period of time between the budget announcement and the effective date of the inclusion rate increase, taxpayers had little time to assess their situation prior to June 25, 2024. This was further compounded by the fact that details of the change were not made available until the Notice of Ways and Means Motion released on June 10, 2024. Upon review of those details, additional concerns were identified, creating further uncertainty for Canadian taxpayers.

Our comments in this submission focus on the ways in which the Proposals, in our view, significantly impact small and medium-sized businesses and entrepreneurs:

- Complexity of the Proposals and the resulting uncertainty
- Lack of integration and tax fairness
- Cumulative tax impact on the Canadian economy

While we understand the ten-week timeline in Budget 2024 was to allow Canadians to adequately plan in advance of these rules, there were challenges for Canadians due to the timing of the announcement, the effective date, and the lack of draft legislation until two weeks before the effective date. Coupled with the latest alternative minimum tax ("AMT") proposals, most Canadians are still uncertain on the actual impact of these changes, and what their tax impact will be for 2024. As mentioned in our recommendations

below, we encourage the Department to engage in collaborative consultation well in advance of draft legislation being released. This will allow for effective change to tax legislation to achieve the Department's tax policy objectives, minimize unintended tax consequences for taxpayers, allow for administrative procedures to be planned out properly, and most importantly, help ensure that any such changes adhere to the principles of certainty, predictability and fairness.

MNP Recommendations

To address the complexity and uncertainty of the Proposals:

Amend the effective date of the capital gains inclusion rate increase such that the two-thirds inclusion rate applies to **taxation years** that begin on or after June 25, 2024. This would have the effect of the new rules coming into effect as of January 1, 2025 for individuals and many trusts. Many of the complex transitional rules introduced in the June 10, 2024 and August 12, 2024 draft legislation would no longer be necessary, including the determination of a blended capital gains inclusion rate for the transition year, as well as the August 12, 2024 additions to adjust a corporation's capital dividend account ("CDA").

To preserve integration and tax fairness for business owners under the Proposals:
Allow for the $250,000 threshold to either apply to all taxpayers (including corporations) or provide for the ability to assign this limit between an individual shareholder and a corporation. It should be noted that precedent for this type of assignment treatment already exists with respect to certain preferential deductions, including the ability to allocate the immediate expensing limits for assets among an associated group of eligible persons or partnerships.

To address the process by which meaningful and effective tax policy should be implemented to minimize the adverse tax impact on Canadian business owners and the Canadian economy:

1. **Engage in collaborative consultation ahead of legislation being tabled.** The government should commit to increased consultation with industry groups and experts before legislation is introduced to Parliament. The government must constructively react to the feedback being provided; otherwise, such consultations will be perceived to have no meaning.
2. **Commit to undertake a deeper study of the cumulative impacts of tax changes on Canadian businesses and other aspects of the Canadian economy.** Including an assessment on the cumulative impact of each new tax measure as well as the potential impact on other areas of the Canadian economy can help minimize unintended consequences.
3. **Ensure greater alignment between the objective of policy changes and the process by which they are administered.** Consultation between government departments and external stakeholders should be utilized to ensure policy objectives are met without causing undue administrative burden on all taxpayers. Thorough planning should be undertaken before changes are implemented to prevent last-minute changes to compliance requirements as we have seen in the past.

DISCUSSION

Complexity and resulting uncertainty of the Proposals

The complexity and uncertainty created with the mid-year effective date for the increase in the capital gains inclusion rate is substantial.

When the intention to increase the inclusion rate was announced in Budget 2024, the description of the changes appeared relatively simple: "for tax years that begin before and end on or after June 25, 2024, two different inclusion rates would apply."[1] This was generally interpreted by the tax community to mean that the existing one-half inclusion rate would apply to gains or losses realized prior to June 25, 2024, and the two-thirds inclusion rate would apply thereafter. The Budget 2024 documents also noted the $250,000 threshold available to individuals would apply to capital gains, net of any current-year capital losses, capital losses of other years applied in the current year, and capital gains in respect of which other capital gains-related exemptions or incentives were claimed. As there was no draft legislation available at the time of the Budget 2024 announcement, taxpayers and their advisors relied on the plain meaning of these descriptions in their decision making ahead of the June 25, 2024 effective date.

However, when the June 10, 2024 draft legislation for these provisions was released – just 15 days prior to the proposed implementation date -- it became evident that the framework for the announced change and the related calculations were much more complex. The draft legislation introduced a blended capital gains inclusion rate to be used for a taxation year that includes June 25, 2024 (the "transition year"), requiring additional complex rules and calculations to determine the actual inclusion rate for a taxpayer at the end of their transition year.

With respect to the $250,000 threshold, instead of applying the threshold on a "net" basis as described in the Budget 2024 documents, taxpayers must instead start with all capital gains at the two-thirds inclusion rate, then perform calculations to determine if they are eligible to deduct certain amounts to arrive at a one-half inclusion rate for those capital gains under the $250,000 threshold. Similar calculations must be undertaken for individuals that have employment income that includes stock option benefits to determine the deduction available to them, as well as individuals who have capital losses of other years available to utilize.

The introduction of the blended inclusion rate in the transition year in the June 10, 2024 proposals also created concern as the draft legislation resulted in adverse treatment for corporations with respect to their CDA. While the Department has taken steps to address these presumably unintended CDA consequences through proposed subsections 89(1.3) and (1.4) in the Proposals, these new provisions add further complexity for taxpayers in the transition year. In particular, subsection 89(1.4) requires a corporation to determine its CDA balance at the end of its transition year. The new rules require multiple calculations and the determination of year end "deemed" capital gains or losses, which can only be completed **after the end of the transition year**. The complexity of these calculations stem from the multiple possible inclusion rates for a transition year and the requirement to determine the appropriate blended rate. In our view, such complications arising from the transitional rules could be prevented through a more practical

[1] Tax Measures: Supplementary Information, 2024 Federal Budget. https://budget.canada.ca/2024/report-rapport/tm-mf-en.html#a6.

approach of applying the increased inclusion rate to **taxation years** that begin on or after the announced effective date of June 25, 2024.

One also cannot help but wonder why an approach similar to the capital gains inclusion rate changes in the year 2000 (from three-quarters to two-thirds, then to one-half) was not adopted. At that time, the implementation of the inclusion rate change was much less complex: three different inclusion rates applied for the three separate periods of the **calendar** year. There was no need for complex deeming rules and separate calculations to be completed to determine a taxpayer's net taxable capital gain or allowable capital loss, or loss and capital dividend account balances. In our view, this is a much more appropriate approach and could provide taxpayers with a level of certainty in estimating their tax liability in the transition year. The complexity that the Department has introduced through the proposed changes is simply at odds with the declaration of "Fair and Predictable Capital Gains Taxation" in the Department's June 10, 2024 news release[2].

The complexity of the Proposals will create a further compliance burden on Canadian taxpayers with capital gains. In our view, it will be very difficult for the average Canadian taxpayer, or the average Canadian accountant (that does not specialize in tax) to navigate the proposed rules to accurately determine their tax liability. In many cases, they will have to seek the advice of tax professionals to calculate their net capital gains and to determine eligibility for any exemptions or deductions. In the absence of clear guidance from the Department or the Canada Revenue Agency ("CRA"), many will rely on their own interpretation of the Proposals, which can result in inaccurate estimates of taxes payable and, consequently, additional interest costs for Canadian taxpayers.[3] Many businesses and their advisors will be ill equipped to deal with these changes. Given the government's stated objective to make the tax system more user friendly and easier to navigate, the changes in the Proposals do quite the opposite.

MNP Recommendation
Amend the effective date of the capital gains inclusion rate increase such that the two-thirds inclusion rate applies to **taxation years** that begin on or after June 25, 2024. This would have the effect of the new rules coming into effect as of January 1, 2025, for individuals and many trusts. Many of the complex transitional rules introduced in the June 10, 2024 and August 12, 2024 draft legislation would no longer be necessary, including the determination of a blended capital gains inclusion rate for the transition year, as well as the August 12, 2024 additions to adjust a corporation's CDA.

Lack of integration and tax fairness for business owners

One of the basic tenets of Canadian taxation is integration. The proposed changes will negatively impact integration for certain taxpayers deriving income from capital gains.

While the introduction of the $250,000 threshold for individuals – and later also extended to certain types of trusts – is welcome news, the unavailability of this threshold to corporations disrupts integration for many business owners that generate capital gains income through a corporation.

[2] *Fair and Predictable Capital Gains* Taxation, Department of Finance Canada, June 10, 2024. https://www.canada.ca/en/department-finance/news/2024/06/fair-and-predictable-capital-gains-taxation.html.
[3] We note that many taxpayers with tax years ending June 2024 & later will be negatively impacted due to the uncertainty created by the Proposals.

Many Canadian business owners utilize private corporations, rather than registered investment products, to build their retirement savings. There is already a cost for such taxpayers as they are already subject to a greater tax on investment income at the corporate level, including reduced access to the small business deduction in some cases. The effect of the increased capital gains inclusion rate will further restrict access to the small business deduction on capital gains characterized as adjusted aggregate investment income ("AAII"). Canadian business owners operating through a private corporation are further disadvantaged by not being able to access the $250,000 threshold.

While the Budget 2024 announcements to increase the lifetime capital gains exemption and introduce the Canadian Entrepreneurs' Incentive ("CEI") appear to be positive changes for business owners, in practice, many business owners will not be able to benefit from these changes. Some business owners cannot sell shares of their private corporation due to industry, regulatory or other constraints. In these cases, they can only sell business assets. This reality, when considered in conjunction with the numerous types of businesses precluded from accessing the CEI, highlights that many business owners will be disadvantaged by the inclusion rate increase while being denied the benefit of any available offsetting exemptions or incentives.

MNP Recommendation
Allow for the $250,000 threshold to either apply to all taxpayers (including corporations) or provide for the ability to assign this limit between an individual shareholder and a corporation. It should be noted that precedent for this type of assignment treatment already exists with respect to certain preferential deductions, including the ability to allocate the immediate expensing limits for assets among an associated group of eligible persons or partnerships.

Cumulative Impact of Capital Gains Inclusion Rate & Other Tax Changes

The current changes to Canada's tax system cannot be considered in isolation. Below we summarize other significant tax changes from the past seven years. Based on our experience, many private companies and their owners have been adversely impacted by more than one of these measures – the cumulative impact of these measures have proven damaging to businesses.

1. **Taxation of Canadian-controlled private corporations (2017).** The federal government introduced a package of measures specifically targeting the taxation of Canadian private companies. The Tax on Split Income rules create uncertainty in their application and generally fail to recognize the total contribution of family members to support operating a family business. The introduction of AAII has been detrimental for Canadian business owners as they restrict access to the small business deduction. Business owners are forced to decide between saving for the future – whether for personal or business use – and managing their tax costs and related cash flow each year.
2. **Trust reporting (T3) requirements.** The requirement for **bare trusts** to be subject to the enhanced reporting rules caused widespread uncertainty. As a bare trust arrangement is a legal concept and is not defined in the *Income Tax Act* ("ITA"), many taxpayers were simply unaware or unsure if they had a filing requirement. While the CRA ultimately announced on March 28, 2024, that bare trusts would generally be exempt from the filing requirement for the 2023 tax year, this announcement came just before the March 30 filing deadline, when many taxpayers had already

invested time and resources to meet their obligations. It remains unclear if the recent August 12, 2024 proposals impacting the enhanced trust reporting rules will adequately address the uncertainty arising from previous years.

3. **Rules on intergenerational business transfers.** The rules introduced through Bill C-208 and enacted in 2021 were welcome news for family businesses. However, the further changes introduced in the 2023 federal budget and enacted in June 2024 are far more restrictive and are expected to be of little relief to those looking to transition their family business going forward. This is an example of the Department having taken a positive step forward to support Canadian family-owned businesses, then negating that by taking a step back.
4. **Underused Housing Tax ("UHT").** The UHT was rolled out in 2022 and created expansive reporting requirements for Canadian residential property owners. The rules were complex and the extensive filing requirements created uncertainty for taxpayers. While the waiver of penalties and interest on late filed 2022 UHT returns and payments announced by the CRA provided some relief, this highlighted the underlying complexity and uncertainty that taxpayers were facing in order to be compliant. Further amendments introduced by the Department in 2023 remain in proposed status despite the 2023 filing deadline now having passed.
5. **Mandatory disclosure rules for reportable & notifiable transactions.** Similar to other recent legislative changes, these rules contain ambiguity in terms of who has to complete the mandatory reporting, while also creating a short time frame to complete the reporting. In some cases, multiple parties will be required to effectively gather and submit the same information to the CRA. These rules add to the heavy administrative burden already placed on taxpayers in order to remain compliant to avoid punitive penalties.
6. **The General Anti-Avoidance Rule ("GAAR").** The recently enacted changes to the GAAR create significant uncertainty as they effectively override years of judicial precedents in interpreting the ITA. Clarity on how the amended rule will apply will likely only be available once it is examined in the tax courts, which is expected to take years.
7. **Alternative minimum tax.** The AMT changes announced in the 2023 federal budget, which were effective January 1, 2024, were not enacted until June 20, 2024, leaving only four days for many taxpayers to confirm the income tax consequences of any planning in response to the capital gains inclusion rate increase.

The constant changes have a compounding negative impact because new rules are being introduced at an alarming rate without guidance on how they impact or interact with existing legislation. It is becoming increasingly difficult for businesses to be compliant as tax laws continue to evolve.

The uncertainty of constant change, the complexity of current tax policy, and the administrative burden on taxpayers discourage entrepreneurship as they increase the economic risk for entrepreneurs. It is shocking to see how recent tax changes disregard the level of risk and hard work that entrepreneurs take on in hopes of achieving business success.

Consider the following consequences that we have seen arising from the increase to the capital gains inclusion rate:

Recruitment and retention of physicians and medical professionals. This change, among others, makes it less attractive for medical professionals to work in Canada. The country is already facing a family physician shortage – doctors are considering retiring early, working fewer hours, and leaving family medicine

altogether. This threatens the quality of Canada's healthcare system, particularly in rural areas struggling to recruit family physicians.

Investment in Canada's technology sector. Technology companies often rely heavily on equity financing to expand their business. The increased inclusion rate results in higher tax liability for investors when they dispose of their shares and realize capital gains, causing investors to reassess their investment strategies. Young entrepreneurs are considering leaving Canada to develop their businesses, highlighting how susceptible this sector is to mobility.

Impact on retirement and estate planning. Business owners planning to fund their retirement with proceeds from the sale of their business are revisiting whether the after-tax proceeds will be sufficient given the increased inclusion rate. Taxpayers relying on life insurance to fund taxes on death face insufficient coverage, and in some instances, taxpayers are now no longer insurable.

Investment carries risk, but the current regulatory uncertainty amplifies this risk. Businesses are hesitant to invest in areas that could be significantly impacted by government policy change. Reduced investment arising from this concern leads to weakening productivity and a lack of innovation.

Repeated instances of tax policy changes not being well implemented has led to a breakdown in trust between taxpayers and the government. Given the increased complexity of compliance and administrative burden across all levels of government in Canada with respect to regulation and tax policy over the last number of years, Canadians face an increasingly complex and cumbersome compliance regime. Failure to recognize the cost of overall administrative and regulatory burden will lead to a less productive business and investment climate in Canada.

MNP Recommendations

1. **Engage in collaborative consultation ahead of legislation being tabled.** The government should commit to increased consultation with industry groups and experts before legislation is introduced to Parliament. The government must constructively react to the feedback being provided; otherwise, such consultations will be perceived to have no meaning.
2. **Commit to undertake a deeper study of the cumulative impacts of tax changes on Canadian businesses and other aspects of the Canadian economy.** Including an assessment on the cumulative impact of each new tax measure as well as the potential impact on other areas of the Canadian economy can help minimize unintended consequences.
3. **Ensure greater alignment between the objective of policy changes and the process by which they are administered.** Consultation between government departments and external stakeholders should be utilized to ensure policy objectives are met without causing undue administrative burden on all taxpayers. Thorough planning should be undertaken before changes are implemented to prevent last-minute changes to compliance requirements as we have seen in the past.

CONCLUSION

Many of the Proposals are overly complex and arise from the multiple potential inclusion rates in a transition year. These will have widespread impact if implemented. In our view it would be more comprehensive to delay implementation of the rate increase by having it apply to transactions that occur after the proposed implementation date. This would negate the need for many of the adjustment provisions contained in the Proposals with the result being a more well understood revision to the ITA. This would also increase taxpayer compliance and allow taxpayers, representatives and software providers to better prepare for the changes.

We request that our points discussed above be given consideration and that if necessary, a stakeholder working group be established to further study this issue. Furthermore, we recommend the Department carefully consider these Proposals and recognize the impact on all taxpayers. Allowing for certainty, predictability and fairness will help ensure taxpayers and investors maintain confidence in government without fear of incurring punitive costs.

MNP is pleased to continue to work with the government, other members of Parliament and policy makers across Canada to further discuss our observations, comments and recommendations in this submission.